Research Insight

CommSec

News from CommSec research

Welcome to this week's edition of the CommSec Research Insight. Each week we share the unique insights of the CommSec Equities Research team based on the research we prepare for institutional clients (ie fund managers). We provide you with a quick wrap on the state of our share market, a few feature articles on the most interesting recent research reports we've issued and snippets on stocks and sectors that have been making the news.

Feature Article

Our feature articles this week are:

- **RIO Tinto Limited**
- **Bank of Queensland**

The comments in the article below are an abbreviated restatement of our analysts' reports.

A glossary of frequently used investment terms can be found at the end of this report

Feature Article

Rio Tinto Limited

Last traded: $81.75	Sector: Mining	Market cap: $149,212m
Buy		Price target: $91.00

Summary of previous report dated 20 October 2010

Pilbara expansion to 283Mt approved

RIO has announced approval for a USD3.1b expansion of its iron ore infrastructure in the Pilbara to take capacity to 283Mtpa in 2013. This announcement follows an announcement on 14 July 2010 of a USD200m dredging program at the Cape Lambert Port. The timing of the expansion appears to have been brought forward by about six months, we speculate in response to the end of the iron ore JV with BHP Billiton. This is the first stage in an expansion that will ultimately move to 330Mtpa, although RIO will not approve the further expansion until it is more confident in the medium-term iron ore outlook. RIO's share of the expansion capex is USD2.1b, and makes up a significant portion of the USD3b 'gap' between announced USD9b capex target in 2011 and previously sanctioned projects of about USD6b.

RIO is outstandingly cheap

We maintain our Buy recommendation and AUD91 price target. Earnings will continue to increase in 2H10 and into 2011. RIO is now generating significant surplus cash flow, which will be used to fund additional growth.

Issue 182 21 October 2010 (4.30pm)

Market Wrap

How wealthy are you feeling? Well, if you believe the latest data, you should be feeling very wealthy.

The Bureau of Statistics has just released the June quarter figures on wealth, and the data shows that Australians have never had it so good. That is, wealth held in property, shares and other assets hit record highs of just under $5.9 trillion at the end of June.

When you consider that we've just been through a global financial crisis, the fact that we've come out the other side and our wealth levels are intact, it's a pretty impressive performance.

Our economists reckon that this wealth equates to $262,500 for every man, woman and child – just $500 below the record high at the end of March. And while inflation-adjusted wealth is still about 6% below the record highs of late 2007, the current wealth levels are still very encouraging.

Why worry about wealth? The main reason is that it is a key factor influencing our spending, so it has importance for retailers and for the economy as a whole. And given that Australians are continuing to cut back on debt, the overall situation is positive for consumer-focussed businesses.

Stephen Karpin
Managing Director

Bank of Queensland

Last traded: $10.50 | Sector: Banks | Market cap: $2,310m

Hold | Price target: $11.28

Summary of previous report dated 14 October 2010

Still seeking a more level playing field

BOQ reported FY10 adjusted cash profit of $197.1m (CBA $197.3m), below consensus of $202m, with a final dividend of 26cps flat hoh. The unexpectedly detailed FY11 guidance surprised with growth 1.5-2x system, flat bad and doubtful debts (BDD) and dividend growth of 10-20%, reducing consensus expectations for FY11. Funding challenges kept pressure on BOQ's margin but we see scope for improvement in FY11 given rebased NIM in 2H10, a shift in loan mix to higher margin business and potential out-of-cycle mortgage repricing. Given a portfolio biased towards SME and consumer lending, BOQ has reached its peak in impairment in 2H10. While BOQ has seen improving trends in loan arrears since April, we believe BOQ's BDD charge will see more gradual normalisation over FY11 and FY12 than the majors, due to the typically longer tail for SME/consumer stress. Capital remains a priority, with an easing in dividend payout ratio. While BOQ continues to outline a pathway to 15% ROE, management acknowledged key dependencies such as NIM and BDD make it difficult to see this as likely by the original FY12 target.

Hold recommendation maintained

BOQ delivered the softer FY10 result we expected, driven by margin contraction, a higher peak in BDD charge and ongoing headwinds facing the sector. Ultimately, the regional banks including BOQ still need better access to competitively priced funding to drive stronger growth and the required earnings boost to lift ROE and valuation upside. That said, material downside seems limited and on a look-through basis, we find BOQ offers greater valuation appeal than BEN.

Sector wraps

Following is a summary of a selection of recent sector reports distributed by CommSec research.

Property	Sector report		
21/10/10	CPA: Last Traded: $0.91	Market Cap: $1,822m	Sector: Property
	CQO: Last Traded: $2.59	Market Cap: $1,278m	Sector: Property
	DXS: Last Traded: $0.83	Market Cap: $3,992m	Sector: Property
	GPT: Last Traded: $2.90	Market Cap: $5,381m	Sector: Property
	IOF: Last Traded: $0.61	Market Cap: $1,665m	Sector: Property
Summary of report dated 18/10/10	CPA: Hold		Price target: $1.00
	CQO: Sell		Price target: $2.51
	DXS: Hold		Price target: $0.90
	GPT: Sell		Price target: $3.05
	IOF: Hold		Price target: $0.62

Office reversion – the next chapter

Given recent commentary regarding impending rent growth across the domestic office markets, we have examined the potential impact of leasing profiles over our forecast period.

Net effective rents (rents adjusted for incentives and outgoings) experienced significant change over the past five years, with steep climbs recorded from 2006-2008 (perhaps with the exception of Melbourne) followed by a sharp decline as a consequence of the GFC.

- Leases struck during the boom years from 2006-08 typically expire 2011-13. As current forecast rents expiry in Sydney, Perth and Brisbane are well below what rents will be from leases as they expire, this will likely create an earnings headwind for office A-REITs.

We maintain our negative bias towards the office sector based on our view of (1) lacklustre NPI growth over our forecast period as negative reversion offsets expected occupancy gains, (2) continued stagnation of Australia's largest office market Sydney as demand remains subdued, and (3) our view of a slower-than-anticipated recovery, with limited earnings growth opportunities for A-REITs in the near to medium term. We reiterate Sells on both CQO (PT $2.51) and GPT (PT $3.05). Our preference remains towards residential and retail A-REITs, where we see more attractive return profiles. Buy SGP (PT $4.77), MGR (PT $1.51) and CFX (PT $1.90).

Stocks at a glance

Following is a summary of a selection of recent reports distributed by CommSec research.

Stocks by sector

Healthcare

SHL[2]
21/10/10

Summary of report dated 15/10/10

Sonic Healthcare Limited

Last Traded: $11.01	Market Cap: $4,277m	Sector: Healthcare
Hold		Price target: $10.46

UK/Ireland public outsourcing – more than talk

Kings College Hospital NHS Foundation Trust has joined GSTS Pathology (GSTS) to form one of the largest pathology providers in the UK. GSTS is a 50:50 JV between Serco Group and Guy and St Thomas' NHS Foundation Trust. Under the arrangement, GSTS was awarded a £300m, 10-year contract to be the primary provider of pathology services for Kings College Hospital.

NHS outsourcing major opportunity for private players in the UK pathology

There have been a limited number of outsourced deals to date. Nevertheless, with Lord Carter estimating £500m in efficiency savings in NHS pathology, growing demand, a fiscal deficit and a Coalition government, further outsourcing opportunities appear inevitable and the Kings College Hospital deal could be the starting point.

Our calculations show that an NHS contract like Kings College Hospital would be 1.8% accretive to SHL's FY12 EPS. Furthermore, SHL is well placed to participate in NHS outsourcing given (1) its available capacity, (2) its eight years' experience operating in the UK pathology market, (3) its successful track record on laboratory integrations and (4) its relationship with The University College London Hospital NHS Trust (which it could leverage off in line with GSTS' approach to the Kings College Hospital deal).

Our calculations show that an NHS contract like Kings College Hospital would be 1.8% accretive to SHL's FY12 EPS. Furthermore, SHL is well placed to participate in NHS outsourcing given

Industry sources claim that the Ireland's Health Service Executive has recently requested expressions of interest for its public pathology work. This work is valued at ~€500m pa and is expected to be split into 2-3 tranches. After winning part of Ireland's cytology work and subsequently investing in local infrastructure and staff, SHL is in a strong position to win a contract. CBA estimates such a contract could be 5.8% accretive to SHL's FY12 EPS.

Potential material earnings upside – but other short term headwinds

While outsourcing appears inevitable in the UK and Ireland and SHL is well positioned to take advantage, we have not factored any upside into our forecasts but do note that it will potentially represent material earnings upside. The stock will face short-term headwinds with uncertainties around industry volumes, collection centres de-regulation and funding as well as a stronger AUD. That said, SHL should comfortably achieve the midpoint of its guided NPAT range. We retain our Hold recommendation.

Happy investing!

Recommendation definitions

CBA Institutional Equities Investment recommendations are determined by the covering analyst and reflect the analyst's assessment of a stock's expected total shareholder return (TSR). TSR is calculated as the difference between the analyst's 12-month price target and the current share price plus the forecast dividend yield.

Buy: Stocks with a Buy recommendation represent the most attractive stocks under the analyst's coverage. They are forecast to generate significantly positive expected total shareholder returns.

Hold: Stocks with a Hold recommendation are less attractive than Buy rated stocks. They are forecast to generate flat to slightly positive expected total shareholder returns.

Sell: Stocks with a Sell recommendation are the least attractive stocks. They are forecast to generate flat or negative expected total shareholder returns.

[2] Members of the Commonwealth Group have received fees within the previous 2 years from SHL

Glossary of frequently used investment terms

2P	proved plus probable	FUM	funds under management
3P	proved, probable and possible	GEP	gross earned premiums
ABARE	Australian Bureau of Agricultural and Resource Economics	GJ	gigajoule
ACCC	Australian Competition and Consumer Commission	GWP	gross written premiums
AGM	annual general meeting	JV	joint venture
APRA	Australian Prudential Regulation Authority	LNG	liquefied natural gas
ARTC	Australian Rail Track Corporation Ltd	L-R	long run
ATO	Australian Taxation Office	MAT	moving annual total
bbl	billions of barrels	Mboe	thousands of barrels of oil equivalent
bbls	barrels	mom	month on month
bp	basis points	MOU	Memorandum of understanding
CAGR	compounded annual growth rate	MRET	mandatory renewable energy target
CCGT	combined-cycle gas turbine	NAV	net asset value
CEO	chief executive officer	NPAT	net profit after tax
COGS	cost of goods sold	NPV	net present value
cps	cents per share	NTA	net asset backing per share
cpu	cost per unit	OCGT	open-cycle gas turbine
CSG	coal seam gas	OIP	oil in place
CSM	coal seam methane	OTC	over the counter
DCF	discounted cash flow	P/E	price-earnings ratio
D&A	depreciation and amortisation	pcp	prior comparable period
DRP	dividend reinvestment plan	ppt	percentage point
EBIT	earnings before interest and tax	PSI	offering into pipelines
EBITDA	earnings before interest, tax, depreciations, amortisation	SOTP	sum of the parts
EPCM	Engineer Procure Construct Manage	TEUs	twenty equivalent units
EPS	earnings per share	VWAP	volume-weighted average price
ETS	emissions trading scheme	WACC	weighted average cost of capital
EV	enterprise value	WIH	work in hand
FTA	free to air	y-o-y	year on year

Disclosure and Disclaimer

End of Report